Amando M Tetangco, Jr: Alpha, Beta, Gamma – measured risk-taking and dynamism amidst challenging times

Speech by Mr Amando M Tetangco, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at the Joint General Membership Meeting of MART-ACI-IHAP-TOAP-NASBI-FMAP, Makati-City, 22 September 2016.

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It is always a pleasure to speak before the six industry associations because you cover the breadth of the Philippine financial market. From among you come the counterparts of a typical investor – traders, brokers, asset managers and underwriters. You span the spectrum of the domestic yield curve. You cover both public and private corporate sector funding and investment requirements. You deal in peso and foreign currency. In other words, ladies and gentlemen, you could move the money, capital and fx markets. And therefore you have power to drive these markets to help raise the growth trajectory of our economy.

A call to action, upfront!

Normally that is how I would end a speech during your General Assembly. I would normally call you to action, just before I close. And I have done so, for over a decade now.

You may wonder why I have chosen to begin my remarks with an admonition this time, instead of putting it off to the end. By tradition, I address this General Assembly only once a year. I don't believe we have anything else scheduled in the 9 months and 10 days remaining in my second and final term. Nine months or three quarters is a long time. Of course, a basketball game has four quarters, but many basketball games have been won (or lost) in the last two minute. In over a decade together, we have built a sound banking system. We raised the bar for professionalism among your ranks. We elevated financial consumer protection high on your radar screens, beyond it being just an advocacy. In other words, we've had a good run, so far, ladies and gentlemen. Let's not drop the ball. Instead, lets go for that lay-up, take the three-point jump shot, sink all our free-throws and do the slam dunk to ensure we finish this game strong.

For certain, the Philippines is in a relatively strong position compared with many AEs and EMEs, even in the region, but we can aim to do better. We can make the financial market an even more effective and safe catalyst for economic growth. In the next few minutes therefore I hope I can encourage you towards this goal, but first let me put this in perspective.

Putting this in context

If we take a step back and look at all the actions of policymakers around the world, the end goal has really been to restore the appetite of investors, so they would move along the financial risk spectrum, encourage asset creation and in the process, reinvigorate real demand that will spur growth and job creation.

But this transmission mechanism has bumped against animal spirits that have somehow been curtailed by the GFC. The GFC and sovereign debt crises have brought about acute liquidity shortage during the crunch that, in turn, encouraged higher demand for risk-free assets and cash holdings.[1] This increased preference for liquidity could have potentially contributed to the global savings glut, and may also explain why amidst abundant liquidity, both growth and inflation remain weak.

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1 Low Profile: Why Rates and Yields Will Remain Depressed, 24 August 2016, Roubini.com

Another viewpoint is that structural factors have hindered the revival of risk-taking. Potential output growth has declined since the GFC, reflecting the impact of aging, and slowing capital and productivity growth in advanced economies.[2] Therefore, the opportunities for real returns are scarce, and the subdued global growth dynamics limit sustainable returns from investments.

A role for the market

This is where you, market players, come in. You need to put back on your economic risk-taking hats (as opposed to your financial risk-taking hats only). I know that whether you are working on behalf of clients or for your own proprietary position, you all have a "return function", some probably call it a "budget". And typically, this is made up of your alpha risks and your beta risks. In basic math representation, consider the Cartesian graph with the Y axis as portfolio return and X axis as market return. Your own return could then be represented by Y=alpha (or the Y intercept) plus beta (or the slope) times X. In other words, Y=a +bX. You may recall this from high school algebra. How high above zero your starting point is, will be determined by your alpha, and how steeply you wish your returns to move across combinations of portfolios will depend on your beta. Because the expectation is that over time your returns should rise, it is important that you clearly map out your alpha and beta risks.

Alpha: where the core return lies

In the context of my remarks tonight, alpha is determined by your macro conditions – the outlook for growth and inflation, as well as the presence of institutions. In the Philippines, we have had 70 consecutive quarters of positive GDP growth nestled by inflation that has been below the upper end of the government target range since 2009.

The strengths of the Philippine economy are plentiful, in contrast to other key emerging economies elsewhere. Domestic demand conditions are supported by solid private household consumption and investment; buoyant business and consumer sentiment; and adequate credit and domestic liquidity. Our current estimates also point to a continued productivity growth in the medium term, backed by upbeat domestic demand and favorable demographics.

Recent banking sector indicators continue to indicate solid asset growth, improving quality of loans, and capitalization above international norms; yet the agenda is long in terms of forging a financial system that strongly enables economic growth.

Clearly, we are standing on a solid foundation. And, we can further build on that foundation by strengthening our institutions. In particular through capital market reforms. Year in, year out, we talk about a capital market roadmap. Let's not make that a roadmap which leads to no-where. Industry leaders, there are many low-hanging fruits – the OIS, the general repo, the single price for bond trading. I am told there are just one or two more wrinkles to these. The end goals are clear – a more reliable and transparent benchmark process. Tapusin na natin ito. Masyado nang matagal.

On the part of the BSP, we adopted the Interest Rate Corridor in June so that through calibrated auctioning, the transmission of monetary policy would improve. That said, I think it is important to remind everyone here that the IRC is an operational adjustment. The BSP policy rate remains the key indicator for our view on inflation. The recent auctions showed that you are becoming more familiar with the IRC system and are responding positively to higher auction sizes. You can expect further upward adjustments to the auction sizes. The

[2] IMF World Economic Outlook 2015 and 2016.

objective is to siphon off a sufficient amount of liquidity such that the gap between the policy rate and the term auction rates would have narrowed and are more closely aligned. Together with refinements in auction sizes, we will continue to implement the agreed phase-out of access by trust entities to the ODF and TDF windows by June 2017.

As conditions warrant, we may also consider reductions in our reserve requirement ratio, which is one of the highest in the region. Indeed, we continue to gear towards more market-oriented policy instruments.

Further to market-oriented policies, the recent FX liberalization measures, particularly the easing of documentary requirements for larger volumes of transactions and allowing resident-to-resident fx transactions should help bring more of the fx transactions back to the formal banking sector.

To recap, alpha is where the core of your return lies. And, it is only as good as your fundamental environment is. Refinements to our operating capacity would therefore allow us to build on these positive fundamentals. As market participants you have to see that these refinements create the potential for “excess returns”.

Beta: market risks, watching for the upside

Now, let’s move on to beta, or the slope of your return curve. In general, the larger the beta, the steeper the return curve. Stated differently, higher returns mean higher risks. A typical portfolio manager would take some high beta risks and mix these with low beta risks to achieve an ideal-risk return portfolio. In other words, managers would assemble his or her basket of assets based not just on individual risk/return ratios, but by how each asset contributes to a portfolio’s overall risk and return.

The same is true for the BSP. We look at the bigger picture in calibrating our policies to promote stability. We look at the pressure points from both the external and domestic sectors, and then adjust our tools accordingly.

Top on this list of pressure points are policy actions of AE central banks. Last night the Fed kept its target funds rate steady. Fed watchers, who analyzed every nuance after the statement was released, highlighted the “divide” in the Fed, which could, down the road, lead to more difficulty in communicating their policy intent. Yesterday afternoon, the BOJ added “yield curve targeting” to its policy framework, signaling that short term rates would remain negative. Earlier this month, the ECB also held rates but signaled it was open to more stimulus. With these AE policy meetings “out of the way” for now (so to speak), there could be a halt in the recent spate of outflows from EMEs, a slowing in currency depreciation pressures in the near-term and reduced market volatility.

As for China, there are no new policy prescriptions coming from authorities lately, but we remain watchful of the potentially bumpy path along its transition from an export-led to a consumption and services driven-economy. We would also be monitoring developments during the transition to Brexit not only on the UK economy, but also in the rest of the EU.

The BSP is helping provide the market with an anchor during these uncertain times by staying on the policy strategy that we have been using. For monetary policy, this means we will continue to be guided by our outlook on inflation, which right now remains manageable. As you know, today, the MB decided to keep policy rates steady. While inflation in 2016 is forecast to average below the lower end of the target range at 1.7pct, we see this gradually rising to within the target range in 2017–2018. The balance of risks surrounding the inflation outlook appears to be tilted to the upside, with pending petitions for utility rates and excise taxes on petroleum products.

In terms of the exchange rate, we will continue to let the exchange rate be broadly determined by market forces. But if there is excessive volatility, then we have room to provide or withdraw dollar liquidity as appropriate.

Let me digress a bit here, this wasn't in the original draft of my speech. But let me deal with the elephant in the room. I know you are not newbies to volatility. Therefore I think it is important that, in all the sociopolitical events surrounding the market today, we should not lose sight of the fact that our macrofundamentals are solid and that these were built over years of deliberate conscientious reforms. Admittedly, markets are run, sometimes "over-run", by sentiment. So, I admonish you to keep your feet on the ground and not be "carried away."

The BSP has the tools to help ride out the volatilities. We can also employ targeted macroprudential tools to bring about a more directed influence on market behavior, if and as warranted.

In turn, we expect that the market would take measured risks – lend to viable projects that generate jobs, create client-suitable products, utilize your liquidity not just for financial assets, make your capital work! Our regulations and our policy framework are geared towards providing a balanced, safe and sustainable operating environment for you. Therefore you have every reason and opportunity to steer your risk-return profile, in a measured way, to a higher gradient (or beta).

Gamma: what's next?

So far, we've talked about alpha, then beta. Next on the Greek alphabet is Gamma. Gamma in finance is the first derivative of delta (which itself is the change in option pricing). For purposes of my talk tonight, let us consider gamma simplistically as a measure of how fast something is changing speed, i.e., the second derivative.

The operating environment we are in is changing, and the rate at which it is changing is quite fast. It may still, however, take some time for the fundamentals of the global economy to fully recover and therefore surprises may continue to impact our shores. Nevertheless, our favorable fundamentals, coupled with ample policy space and tools, and supported by a proactive reform agenda, gives us confidence that the risks in the horizon are manageable. Clearly, these factors support a positive basis not only for measured risk-taking but also dynamism in the industry as we continue to deepen our capital markets and further increase the efficiency of financial intermediation.

Final thoughts

Alpha, Beta, Gamma... Let me conclude by saying that gamma can also stand for Go! We need industry players like you to GO and seize the opportunities that are being offered by a robust growth momentum. The economy has what it takes to overcome "headline risks", but you must GO and create opportunities that will enhance our overall competitiveness as a destination for doing business.

On that note, I wish you all a productive and profitable year ahead of you. Mabuhay kayong lahat!